CGT: a new reason for letting go

Stephen Chater explores capital gains tax changes, what's involved in setting up an employee ownership trust and considerations a financial adviser would wish to raise with their client

Do you have any clients who would like to pay 0 per cent capital gains tax on selling their business, using a new statutory tax relief? If so, read on, because the government is introducing such a rate for certain types of business disposals (after 6 April 2014).

Two new tax reliefs in the Finance Bill 2014 are designed to encourage and support the creation and growth of employee-owned companies. These are likely to be of particular interest to businesses whose owners are considering retirement and are grappling with succession issues.

The emotional connection with a business built up over many years could mean that selling to a third party has limited attractions. Disposing of the business to employees who have been involved in its development and who are more likely to share the same values and vision may have greater appeal, especially if this can be achieved on advantageous terms.

Such an approach can also offer job security and a continuing stake in the business for employees, creating conditions that help maximise the business's future prospects. Research shows that employee-owned companies outperform other companies in a number of ways, and the government wishes to encourage more employee ownership, which can take the form of:

- direct ownership (where employees hold shares in their employing company)
- indirect ownership (where shares are held collectively on behalf of all employees, often through an employee trust); or
- some sort of combination of the above.

Existing tax-advantaged share plans (EMI, tax-advantaged options, and share incentive plans) encourage employees to make direct acquisitions of shares in their employing company on an individual basis. Until now, there have been no tax incentives for holding shares indirectly on behalf of employees.

Under the first new tax relief, the sale of a controlling interest in a company to an indirect employee ownership structure (to be known as an employee ownership trust) will be entirely free from CGT.

An employee ownership trust (EOT) must meet certain specific conditions that are designed to target the relief appropriately and to reduce the opportunities for tax avoidance:

- The company must be a trading company or, where there is a group, the principal company of a trading group.
- The EOT must meet the 'all-employee benefit requirement'.
- The EOT must not hold a controlling interest in the company before the disposal, but must do so at the end of the tax year in which the disposal takes place.
- Where the transferor has an interest of more than 5 per cent in the company in the 12 months before the disposal, the ratio of employees who are 5 per cent shareholders to employees generally must not exceed 2:5.

The relief operates as if the disposal is made for an amount that gives neither a gain nor a loss to the transferor. If the EOT ceases to control the company or ceases to satisfy the qualifying conditions, the EOT trustees will incur a CGT charge (but the individuals who sold their shares to it will not).

An EOT resident outside the UK

would, however, under general tax rules, have no liability to CGT.

The all-employee benefit requirement means, broadly, that if the EOT provides benefits (such as cash or shares) to individual employees, it must generally do so in favour of all eligible employees on the same terms (the 'equality requirement').

The EOT cannot, therefore, confer disproportionate benefits to the advantage of particular employees, although it can allocate benefits of differing amounts by reference to objective factors such as salary, length of service or hours worked.

During consultation, the government accepted that it could be difficult for existing employee trusts to satisfy the all-employee benefit requirement without significant changes to their constitutional documents.

It has, therefore, introduced deeming provisions to the Finance Bill whereby an existing trust can be deemed to meet the all-employee benefit requirement, if, broadly, (a) the way in which it operates is consistent with the all-employee benefit requirement, (b) it had at least a 10 per cent shareholding in the underlying company at 10 December 2013 and (c) it subsequently obtains control of the company.

The new relief is available for disposals on or after 6 April 2014, assuming the Finance Bill is enacted.

“It is essential that careful thought is given to creating practical and sustainable employee ownership structures”

So this initiative opens up attractive new opportunities in succession planning, particularly as the government also proposes to improve the inheritance tax (IHT) regime for employee trusts. Some existing employee trusts will not automatically meet the EOT requirements. If, therefore, a trust wishes to qualify as an EOT, the trustees will need to amend the terms of the trust deed or resettle property in a new trust.

Ownership succession by selling to an employee trust has grown in popularity in recent years, but is not yet widely understood and has so far been chosen by only a small proportion of companies.

However, it is generally no more complex than a trade sale and is usually simpler. In particular, it is attractive to companies whose value largely derives from the talents of its employees. One important practical point is that a seller or sellers wishing to benefit from full CGT relief on the sale of 100 per cent of their company will need to ensure that the EOT buys the entire holding in a single tax year.

Second proposal

The government's second proposal concerns tax-free bonuses. From October 2014, a company controlled by an EOT that meets the qualifying conditions can pay its employees cash bonuses of up to £3,600 per tax year, which will be free of income tax (but not National Insurance contributions). The government has announced an increase in the funding allocated to this initiative from the originally proposed £50m to £70m per annum.

The main conditions for the income tax relief are:

- The employer company must be a trading company or a member of a trading group.
- A controlling interest in the company or, in a group situation, the principal company of the group, must be held by an EOT.
- The company paying the bonus must be controlled by an EOT throughout the qualifying period (normally, the 12 months prior to payment).
- Provisions very similar to the equality requirement for the CGT exemption also apply to the income tax exemption.
- The company should not have more than a ratio of 2:5 for office holders and directors to employees.
- There is a maximum limit of £3,600 per employee per tax year.
- The payment must not consist of normal salary (so that, for example, it cannot be part of a salary sacrifice arrangement), must not be made by a service company and must be made under an arrangement under which:
  - all employees of the company, or, where there is a group, any group company must be eligible to participate in any award (although employees with continuous service of less than 12 months can be excluded); and
  - all employees participating in the arrangement must do so on equal terms (although awards can be determined by reference to pay, length of service or hours worked).

The income tax relief will apply to payments on or after 1 October 2014, but given the 12-month qualification requirement, it is unlikely that any qualifying payments will be made before tax year 2015/16.

Any company that becomes (or already is) majority owned by an EOT should investigate this new relief further. It doesn't prevent bonuses also being paid on a discretionary basis to selected employees, but these will not, of course, benefit from the tax exemption. Any company owned by an employee trust may consider converting to an EOT to take advantage of this relief.

These initiatives are to be warmly welcomed and should open up opportunities for attractive alternative strategies for businesses considering ownership succession. The government believes that UK business will benefit from a growth in the number of employee-owned companies.

If its objective is to be achieved, it is essential that careful thought is given to creating practical and sustainable employee ownership structures. ■

Stephen Chater is share plans director at Postlethwaite Solicitors (www.postlethwaiteco.com)